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Tax

Tax Reform to Increase Cost of Higher Education

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Introduction

The costs of higher education have risen rapidly in recent years due to increases in tuition and related expenses. Unfortunately, tax reform appears to make the prospect of a college education even more costly for many students. The Tax Reform Act of 1986 (TRA '86) has greatly changed the tax treatment of educational grants and deductible expenses. Many scholarship and fellowship grants are now taxable to recipients, and those educational expenses deductible under prior law are reduced or eliminated. As a result, education is likely to be more costly in the future and will require greater record-keeping by students. This article examines the new rules and suggests several planning opportunities to minimize the burden of educational expenses.

Taxation of Educational Grants and Awards

Scholarships and Fellowships

Grants after August 16, 1986. Under prior law,¹ scholarships and fellowships granted to degree candidates were excludable from income unless they were compensation for certain services (e.g., teaching and research not required of all candidates). Nondegree candidates were

allowed a limited exclusion as well. TRA '86 eliminates the exclusion for nondegree candidates and provides that only grants used for qualified tuition and related expenses (books, fees, supplies and course-required equipment) of degree candidates remain tax-free.² Thus, amounts used to pay expenses such as room and board are included in the student's gross income. The new rules apply to tax years beginning after 1986 but only for scholarships and fellowships granted after August 16, 1986.

The Internal Revenue Service recently explained how the new rules work.³ A scholarship or fellowship is considered granted before August 17, 1986 (and therefore subject to the prior, more favorable, rules), if the grantor made a firm commitment before that date to provide the student with a fixed cash amount or a readily determinable amount. If the grant is for more than one semester, amounts received in future semesters are treated as granted before August 17, 1986, if (1) the amount awarded in the first semester is stated as a fixed cash amount or readily determinable amount, (2) the grantor has agreed to provide the grant in future semesters, and (3) the student is not required to reapply to receive the future amounts.

Example 1: On August 1, 1986, Anne is awarded a four-year scholarship in the amount of \$4,000 per year. This award is a fixed cash amount (\$4,000 per year) and the entire award is treated as granted before August 17, 1986. If Anne had received a four-year scholarship for "tuition and books" each year instead of \$4,000 per year, the scholarship would still qualify as a pre-August 17, 1986, grant since the amount of tuition and books is readily determinable. In both cases, Anne may exclude the amounts received from gross income.

If the scholarship does not describe amounts for subsequent semesters as either fixed or readily determinable amounts, the IRS presumes that the amount granted before August 17, 1986, is equal to the amount granted in the initial semester.

Example 2: On May 1, 1986, Bruce is notified that he is to receive a scholarship to attend State University. The grant provides funds for four years (\$5,000 for the first year) and does not require that Bruce reapply to receive the funds for the final three years. The notice does not specify the funds to be received in the second through fourth years, however. The \$5,000 received in year one, being a fixed cash amount, is excluded from income under the pre-August 17, 1986, grant rules. In addition, \$5,000 per year is treated as granted before August 17, 1986, during the remaining three years. Therefore, if Bruce receives \$6,000 in year four, only \$1,000 is treated as granted after August 16, 1986.

The \$1,000 received in year four in Example 2 above will be tax-free only if it is spent on tuition or other course-related expenses. If used for room and board or incidental expenses, the \$1,000 is gross income to the student in the year received.

Education is likely to be more costly in the future and will require greater record-keeping by students.

Dependent students. Including certain scholarship and fellowship

grants in gross income raises the question of whether students still qualify as dependents to be claimed on their parents' returns. Parents must provide more than half of a child's support in order to claim the child as a dependent.⁴ Prior law excluded scholarships (then nontaxable) from the definition of support, thereby allowing parents to meet the support test even when the scholarships were substantial.⁵ Are the rules the same for taxable scholarships after 1986? Apparently so. TRA '86 leaves the support definition intact even though part or all of the scholarship may now be taxed to the student. Parents are not directly affected by their child's taxable scholarships and may continue to define support in the same manner as before.

On the other hand, students eligible to be claimed as dependents on their parents' tax return face two changes that affect their own tax returns in 1987 and later years. First, children are no longer allowed a personal exemption on their own returns if claimed by their parents.⁶ Second, children claimed on their parents' return are allowed, on their own return, a standard deduction of the greater of \$500 or earned income up to the basic standard deduction amount⁷ (\$2,540 in 1987 and \$3,000 in 1988). Solely for this purpose, any amount of a scholarship or fellow-

ship grant that is included in gross income constitutes earned income.⁸ The effect of these changes is shown in the following example.

Example 3: A dependent student has wages of \$3,500, a tuition grant of \$1,600, a room and board scholarship of \$3,000, and no itemized deductions. The student's tax liabilities for 1986, 1987 and 1988 are calculated below. Note that in each year the tuition grant remains tax-free, but the room and board scholarship is included in income in 1987 and 1988.

Including certain scholarship and fellowship grants in gross income raises the question of whether students still qualify as dependents to be claimed on their parents' returns.

The additional tax liabilities of \$522 and \$525 result from the loss of the personal exemption and the inclusion of the room and board scholarship in gross income. Note that the average tax rate increases from 13 percent (\$522/\$3,960) in 1987 to

15 percent (\$525/\$3,500) in 1988. From this example, it appears that students will finance a greater portion of their education with after-tax dollars, a factor likely to increase education costs despite lower tax rates after 1986.

Educational Prizes and Awards

Educational institutions frequently offer prizes and awards to students. Prior law allowed an exclusion for educational prizes and awards unless they were compensation for services performed. TRA '86 repealed this exclusion except where the recipient assigns the prize or award to a governmental unit or tax-exempt charitable organization.⁹ In this case, the amount assigned is excludable from income and no charitable deduction is allowed. For most students, then, educational prizes and awards are fully includable in gross income. These rules apply to prizes and awards received after 1986.

Reporting and Withholding Requirements

The educational institution. As under prior law, educational institutions and other employers must report a student's compensation for services and applicable withholdings on Form W-2. However, the new laws affect the reporting and withholding requirements of these employers in two ways. First, where a portion of a scholarship is granted in return for services, the grantor must make a good faith allocation to determine the compensation amount.¹⁰ This allocation should be based on factors such as (1) compensation paid for similar services performed by non-scholarship students, (2) compensation paid to full- or part-time employees who are not students, and (3) compensation paid by educational institutions, other than the grantor, for similar services performed by students or employees. The compensation is subject to regular reporting and withholding requirements while the scholarship portion, if taxable, is to be reported by the student (see next section).

The second change affects educational institutions and other grantors providing U.S. scholarships to nonresident aliens. The grantor must withhold 14 percent on the taxable portion of scholarships paid to inter-

	1986	1987	1988
Wages	\$3,500	\$3,500	\$3,500
Tuition grant	—	—	—
Room and board scholarship	—	3,000	3,000
Adjusted gross income	\$3,500	\$6,500	\$6,500
Standard deduction*	n.a.	2,540	3,000
Personal exemption	1,080	—	—
Taxable income	\$2,420	\$3,960	\$3,500
Tax liability**	\$ 0	\$ 522	\$ 525

* Greater of \$500 or earned income (\$6,500), limited to \$2,540 in 1987 and \$3,000 in 1988

** 1987: $11\% \times 1,800 = \$198$
 $15\% \times 2,160 = 324$
\$522

1988: $15\% \times 3,500 = \$525$

national students unless a tax treaty in place provides otherwise.¹¹ A 30 percent withholding tax applies to non-degree candidates although proposed legislation would reduce this to 14 percent. Many existing tax treaties do not override this provision and, accordingly, most educational institutions will be forced to report and withhold tax on the taxable portion of scholarships granted to international students. These rules are effective for years beginning after 1986 but only for scholarships and fellowships granted after August 16, 1986.

The student. Apart from compensation required to be reported by the employer, the burden of reporting taxable scholarships or fellowships falls on the student. The grantor is not responsible for reporting taxable grants (i.e., no Form 1099s must be filed) although the IRS recommends that grantors formally advise recipients about amounts subject to the new rules. Due to the large volume of scholarships and fellowships at educational institutions, it is unlikely that all institutions will follow this advice, requiring students to determine their own taxable income from grants received. Given students' general unfamiliarity with tax matters beyond the Form 1040A, the potential for miscalculating taxable grants appears substantial if adequate instruction is not provided.

The task for students is two-fold: (1) determining whether the scholarship or fellowship is subject to tax, and (2) if it is, calculating the amount of gross income to report. To answer these questions, students should do the following:

1. Determine the grant date of the scholarship or fellowship. If the grant date is prior to August 17, 1986, under the circumstances explained earlier in Examples 1 and 2, the grant is nontaxable and no reporting is required. This is true even in the case of multiple semester grants. If the grant date is after August 16, 1986, the scholarship or fellowship may be subject to tax.
2. Determine the taxable amount of scholarships or fellowships granted after August 16, 1986, by analyzing how the grant was used. Amounts spent on tuition,

books, fees, supplies and equipment are excludable from income. Amounts spent on room and board and incidentals should be reported on the student's tax return as gross income in the year received.

3. Maintain adequate records of awards and related expenditures (e.g., tuition bills, book receipts, etc.) The burden of proof is on the student to establish that grants were used for nontaxable purposes.

Once the taxable portion of grants received has been determined, the student must then compute the projected tax liability to determine whether estimated payments or increased withholding is required. Taxable scholarships and fellowships are not treated as wages and are not subject to Sec. 3102 (FICA) or Sec. 3402 (income tax) withholding.¹² However, estimated payments are required if the annual tax liability is at least \$500. In addition, dependent students who have both wage and nonwage income can no longer claim an exemption from withholding on their wage income if their total income is greater than \$500. Students who fail to make sufficient tax payments through withholding or quarterly estimates may face underpayment penalties and interest on their tax returns after 1986.

In summary, early planning and a clear understanding of the tax law are the best offense to minimizing the student's reportable income. While keeping detailed records may be inconvenient, it becomes worthwhile when the alternative is a larger tax liability.

Deductibility of Educational Expenses

Individual Taxpayers

Unfortunately for individuals, TRA '86 did not stop at taxing educational grants and awards. Educational expenses deductible under prior law are now curtailed by several provisions. The expenses must continue to be incurred in improving or maintaining existing skills or to meet requirements set by an employer or by law, but the deduction is now limited to expenses greater than two percent of adjusted gross income.¹³ The qualifying expenses (e.g., job-related tuition, books, fees, supplies

and transportation) are unchanged, but they must now exceed the two percent floor. Students must itemize in order to deduct these expenses, so their total itemized deductions must exceed \$3,000 in 1988 to benefit from these expenses. Note also that meals incurred in connection with educational activities away from home are only 80 percent deductible before applying the two percent restriction.¹⁴

Any amount of a scholarship or fellowship grant that is included in gross income constitutes earned income.

Graduate students may be able to deduct educational expenses related to their now-taxable assistantships if the expenses are incurred to improve or maintain existing skills or meet employer requirements. Tuition, books, and related expenses may be deducted if the student itemizes deductions and the expenses exceed two percent of adjusted gross income.

Another change disallows deductions for travel taken as a form of education.¹⁵ Thus, foreign language teachers who travel to other countries to improve their general speaking skills are no longer allowed to deduct the cost of their trips. A deduction is allowed for travel expenses where the individual engages in educational activities such as performing specific library research or attending classes not available elsewhere. With careful planning, therefore, the foreign language teacher may still qualify for an educational deduction, subject to the two percent floor noted above.

One other change phases out the deduction for interest on educational loans, beginning in 1987. Interest deductions are reduced through 1990, after which the interest is non-deductible.¹⁶ This disallowance may be avoided if the loans are secured by a qualified residence (i.e., first or second residence) of the taxpayer.¹⁷ However, these loans cannot exceed certain amounts, and parents may be reluctant to finance a child's edu-

cation using their home as collateral. The cost of financing education through loans will therefore rise with the loss of interest deductions.

Employer Plans

Employers who provide educational assistance to their employees fare better than individuals with respect to deductions. Employers may continue to deduct educational assistance payments made to employees, and employees may exclude the employer reimbursements from gross income, provided that the plan is nondiscriminatory (within the meaning of Sec. 414(q)) and the payments do not exceed \$5,250 per employee per year.¹⁸ Educational assistance provided to an employee's spouse or dependents does not qualify for exclusion, however, and must be reported as gross income to the employee. Educational assistance plans are especially valuable to employees who are not pursuing degrees because tuition and related expense reimbursements that would otherwise be taxed may be excluded from income. These provisions were

extended for two years and are effective through December 31, 1987.

Planning

As can be seen, the taxation of educational grants and awards, coupled with fewer educational expense deductions, increases the cost of obtaining an education. While individuals may have greater disposable income due to lower tax rates, more after-tax dollars will be required to finance education. Careful planning, however, can reduce the negative effects of tax reform on educational grants and deductible expenses. The following suggestions are offered:

- If possible, students should have the grantor designate scholarships and fellowships as unrestricted. A grant designated for room and board is fully taxable even if a portion of the proceeds is used for nontaxable purposes.
- Upon receipt of unrestricted grant proceeds, students should first apply the proceeds to nontaxable items (e.g., tuition) in order to minimize taxable income. The law allows students to allocate the proceeds in whatever manner they choose, thereby providing the opportunity to reduce the amount includable in income.
- Students must maintain detailed records of the use of scholarship and fellowship proceeds. The burden of proof to show the grant was expended for nontaxable purposes falls on the student, not the grantor.
- Individuals interested in deducting travel as a form of education must engage in educational activities not available elsewhere and must be able to substantiate their claim. Similar research or classes available nearby will negate the possibility of a travel deduction.
- If loans are used to finance an individual's education, consideration should be given to loans secured by a qualified residence. The tax benefit of the interest deduction must outweigh the risks of using the residence as collateral.
- To the extent possible, employees (especially non-degree candidates) should participate in em-

ployer educational assistance plans. The benefits are tax-free to employees and remain fully deductible by the employer.

While the above suggestions are not remedies available to all taxpayers, they may help many to minimize the ever-increasing expense of obtaining quality education. Ω

NOTES

1. Code Section 117, prior to TRA '86 amendments.
2. Code Sections 117(a) and (b), as amended by TRA Section 123(a).
3. IRS Notice 87-31, 1987-17 I.R.B. 13, Internal Revenue News Release IR-87-55, April 13, 1987.
4. Code Section 152(a).
5. Code Section 152(d); Reg. Sec. 1.152-1(c) continues to show scholarships as excluded from determining support.
6. Code Section 151(d) (2), as amended by TRA Section 103(b).
7. Code Section 63(c) (5), as amended by TRA Section 102(a).
8. Conference Committee Report No. 99-841, 99th Cong., 2d Sess. II-17 (1986-3).
9. Code Section 74(b), as amended by TRA Sections 122(a) (1) (A)-(D).
10. See Note 3.
11. Code Section 1441(b).
12. See Note 3.
13. Code Section 67, added by TRA Section 132(a).
14. Code Section 274(n), added by TRA Section 142(b).
15. Code Section 274(m) (2), added by TRA Section 142(b).
16. Code Section 163(h), added by TRA Section 511(b).
17. Code Sections 163(h) (3) and (h) (4), added by TRA Section 511(b).
18. Code Sections 127(a) and (b), as amended by TRA Section 1162(a).



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